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Hon. Charles E. Grassley, Chairman

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Taxpayer Beware: Schemes, Scams and Cons

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Mr. Chairman and members of the Committee, I thank you for the opportunity to appear to discuss the growing problem of fraudulent schemes that are directed towards taxpayers. I am Jay D. Adkisson, an asset protection attorney and an investment advisor. I am also the creator of Quatloos.com, a private Internet website that warns the public about various sophisticated tax frauds and financial frauds.

AN INDUSTRY OF FRAUD

Our country is faced with a growing industry of scams and frauds, an industry much like any other service industry, except that scam artists have little overhead and typically evade the payment of taxes – advantages that make the scam industry very efficient and profitable.

In the past, most fraudulent schemes were run by small groups of scam artists and were relatively isolated. Today's fraudulent schemes take advantage of the Internet to market their scams to a wide audience, and to recruit otherwise innocent people as referral agents and resellers of these schemes.

Fraudulent schemes exact a significant toll upon our economy, our families, and our society.

First, there is the economic impact upon the thousands of citizens who daily lose substantial moneys, and often their entire life savings, to scam artists. Not only is this an immediate loss of moneys otherwise available in the economy for legitimate investments, but also it creates a longer-term problem of increasing the rolls of those who will not be able to provide for themselves after retirement.

Second, there is social impact caused by fraudulent schemes that tends toward the destruction of the family unit, by causing extreme embarrassment and shame to the crime victim. The elderly, in particular, are often afraid to admit to their families that they have been defrauded for fear that it will demonstrate that they are incompetent, leading them to be placed in a nursing home.

Third, and worse, the victims of fraudulent schemes, especially as they relate to schemes involving the payment of taxes, often become disenfranchised and speak with increasing negativity about the U.S. government (which they view as the culprit for not stopping them from being scammed), thus creating a cycle of anti-government paranoia that the scam artists feed upon. Indeed, a large cottage industry of "Patriots for Profit" exists to sell bogus literature, kits for "renouncing" citizenship, etc., to those who have been disenfranchised.

Tax Frauds

In the last two years, the greatest increase in the perceived frequency of frauds has come on the tax front.

Pure Trusts. Despite attempts by a large number of websites to warn about them, and several high-profile prosecutions initiated by the IRS, so-called “Pure Trusts” are still a common form of tax scam. These are trusts that purport to be based on the Contract Clause of the U.S. Constitution; fittingly, they are sometimes referred to as “Con-Trusts”, not because of any constitutional issues, but rather because they are marketed by con men.

“Pure Trusts” are sold via the web, to church groups, at mass seminars, but now primarily by multi-level marketing programs that reward their members based not only on how many Pure Trusts they are able to sell, but also how many other people they are able to recruit to sell Pure Trusts.

Tax-Protestors. The frequency of scams involving so-called “tax protestors,” *i.e.*, persons who do not believe that they are required to pay income taxes under a variety of bizarre theories, is continuing to increase. Many scams are based on long-discredited tax protestor arguments, such as false claims that the Sixteenth Amendment was never properly ratified, or that the only U.S. citizens subject to tax are residents of federally administered territories such as the District of Columbia, Puerto Rico and Guam. More recent tax protestor scams have been more innovative, such as those relating to withholding issues and tax credits.

Offshore Tax Evasion. Despite recent pressures from the OECD and G-8 countries, many small countries encourage U.S. taxpayers to use their offshore financial centers to hide money abroad. Incentives include bank secrecy legislation, which effectively blocks any information sharing with U.S. tax authorities. The use of foreign entities owned by bearer shares to act as foreign services corporations continues to represent a major area of abuse. Although the Internal Revenue Service has taken important steps to highlight the illegal nature of such conduct, including several recent actions against high-profile promoters of offshore tax scams, there still exists a perception that there is little risk of being caught for offshore tax evasion. This perception is not assisted by the continued viability of certain corporate tax shelters, which take advantage of the laws of the offshore tax havens and perceived inconsistencies in the Internal Revenue Code to avoid hundreds of millions (and sometimes billions) of tax dollars per transaction.

One by-product of offshore tax evasion is the creation of phony offshore banks, which purport to hide cash from U.S. tax authorities, but are actually mechanisms for scamming the depositor’s cash outright. Of approximately 30 banks licensed by the government of Grenada, for instance, most of these banks have turned out to be scams. Another by-product of offshore tax evasion is that the same laws that are designed to

encourage U.S. citizens to commit tax evasion are also available to scam artists to hide the criminal proceeds of their schemes.

Financial Frauds

Despite the efforts of the SEC to educate the public about scams such as “prime bank” and “bank debenture” schemes, the frequency of financial frauds continues to increase. Many of these schemes have purported tax avoidance features.

Attempts to Educate vs. Cyber-Terrorism

In addition to the websites of various federal and state agencies, several private websites now attempt to educate the general public about various scams. Unfortunately, these private websites (including ours) have been the subject of denial-of-service attacks by those seeking to silence criticism of their fraudulent programs, a form of cyber-terrorism that underscores the importance to scam artists of the Internet.

ROOT CAUSES

Multi-Level Marketing: The Breeding Ground for Scam Artists

Once a scam artist creates a fraudulent scheme, he needs a mechanism by which to market the scheme quickly and efficiently to as many people as possible. For this purpose, multi-level marketing is ideal.

Essentially, the scam artist can recruit many people to promote the fraudulent scheme by offering them not only a commission to sell the product, but also a continuing commission (or “tail”) for recruiting additional victims to perpetuate the scheme as resellers. Because the scam artist has little or no overhead and typically evades the payment of taxes, he can pay out large commissions and other inducements to sell the product and to recruit others to sell the product. Thus, scam artists can offer higher commissions and payouts than other programs.

Multi-level marketing helps scam artists identify people and groups who are susceptible to scams. Scam artists will often recruit successful multi-level marketers with access to existing “downlines” of other recruiters who have access to certain groups, such as churches or political organization.

Otherwise innocent people find themselves victims of a collapsed multi-level marketing program. As a result, they are often looking for a new program to quickly replace lost income. This makes them prime targets for scam artists offering promises of generous and immediate commissions.

Support for Scam Artists

The industry of scams and frauds includes support businesses that – though technically committing no crimes themselves – richly and unjustly profit by providing support to scam artists.

Telecommunication Services. For example, various businesses cater to multi-level marketing (MLM) programs by offering cheap and easily accessible “800” numbers with access numbers used to track commissions from sales of the program, conference call services, and credit card clearing services, and with little or no background checks of those buying the services, or other screening as to the legitimacy of the opportunity being offered. These services are readily available to the fraud artist to market and to sell today’s fraudulent scheme on a mass basis.

Internet Bulletin Boards. Other willing accomplices include Internet bulletin board services that derive banner-advertising revenues based upon the number of “hits” a certain web page receives. Web pages that promote scams typically have high hit counts, and are thus more profitable to the owners of the bulletin board services. Hit counts are high since the scam artists use the boards as a “resource” to prove that the fraudulent scheme is legitimate. Hit counts increase as victims of the scheme come forward to criticize the program, then as the scam artists respond to defend the program. The increased traffic results in higher advertising revenue for the bulletin board service. The bulletin board services typically ignore complaints that their boards are being used to perpetrate fraudulent schemes.

Spamming. Various persons profit by selling “spamming” services (*i.e.*, the mass sending of unsolicited commercial e-mail); not so much to the instigators of fraudulent schemes, but more often to the people they recruit, with the leaders getting a kick-back from the spammer. This results in literally billions of unsolicited e-mails being sent annually, which reduces available bandwidth and harms the reputation and reliability of the Internet generally. And, as unbelievable as most of the spam advertisements are, they are invariably successful in attracting a number of new victims for the fraudulent scheme.

Bogus “Educational” Websites & Shills

A new phenomena created by the Internet is the “educational” website set up by scam artists as a third-party “resource” to prove the validity of their fraudulent scheme. This bogus website is invariably set up to look like a legitimate website, and sometimes even like a governmental website, but it actually contains false and misleading information so as to bolster the credibility of the scam artist’s story.

Another phenomena is the use of “shills,” being persons who are hired by the scam artists to post on various bulletin boards, etc., information that supports the scam and discredits those who would warn about the scam. Even after the scam has ended,

these skills remain on the Internet to promise victims that the program is still on going and will pay out soon, and to discourage victims from cooperating with law enforcement.

Enforcement Difficulties

It is apparent that law enforcement is having a difficult time keeping up with the growing number of Internet scams. This can be attributed to the sharply increasing number of such scams, and that law enforcement resources typically seem to be directed at after-the-fact punishment of promoters (and sometimes the victims, as in the case of tax frauds), rather than immediate investigation of certain ongoing schemes.

Federal vs. State. An obvious problem for persons wanting to report a fraud, including victims, is whether to contact their local authorities, who may be ignorant of sophisticated schemes, or contacting the federal authorities, who may perceive the matter to be of local importance only.

Federal vs. Federal. Another problem for persons desiring to report a fraud is determining which federal agency to report the fraud to. Programs such as the Internet Fraud Complaint Center¹ and Consumer Sentinel² are significant steps in the right direction, and should be encouraged and expanded.

Non-Traditional Crimes/Aiding and Abetting. Just as the legal and financial professions are creating new and unique planning structures and products, so are the scam artists creating new and unique scams.

Consider, for example, the “fake country” scam. Scam artists will create an entire “virtual country,” complete with executive, judicial, and legislative branches. These fake countries then sell passports and corporate and bank charters. Some have even gone so far as to sell “government bonds.”

The longest running example of the fake nation scam is the so-called “Dominion of Melchizedek” which for years has been run out of the central California area. The Dominion has from time to time claimed parts of the Antarctic and underwater reefs in the Pacific as its territory. Yet, the lack of any physical territory has not prevented the Dominion from creating bogus corporations, banks, and other structures that are then used by criminals to perpetrate various forms of financial fraud, including a bogus mining stock scheme. For whatever reason, the promoters of the Dominion of Melchizedek (who themselves have criminal records) have managed to avoid prosecution.

Foreign Criminals. Finally, as fraudulent schemes are busted in the U.S., the promoters simply move outside of the U.S. to perpetrate their schemes via the Internet. Typically, offshore jurisdictions are used for this purpose.

Code Complexity/Culture of Non-Compliance

The present complexity of the Internal Revenue Code is a significant factor that favors those who perpetrate tax scams. The typical victims of tax schemes are unable to comprehend the Code in a way that would alert them to the fallacies of various schemes. Instead, they must rely on a trained tax professional that, the victim is told by the scam artist, has a vested interest in seeing that the victim complies with the tax code so as to generate fees.

Likewise, the growth and increasing visibility of so-called “corporate tax shelters” has given credibility to scam artists. If a large accounting firm can create hundreds of millions of dollars of deductions for large corporations, seemingly out of thin air by strange interpretations of vague code provisions, then it seems more realistic that an individual seeking to avoid a much smaller amount of tax could similarly benefit from strange interpretations of vague code provisions.

AVAILABLE SOLUTIONS

Possible solutions available to policymakers to stop the growth of the scam industry may include the following:

- Implement federal and local enforcement action aimed at identifying and stopping fraudulent schemes at the outset before they grow into major criminal operations.
- Require registration of multi-level marketing schemes with the SEC, with state securities regulators, and/or the FTC, with criminal penalties for non-registration.
- Require registration of unsolicited e-mail marketing campaigns, with criminal penalties for non-registration.
- Criminalize conduct that is intended to aid and abet fraudulent schemes, or require better self-regulation of Internet bulletin boards, etc., to prevent promotion of known types of fraudulent conduct.
- Increase all law enforcement agencies’ programs to educate the public about fraudulent schemes, and dramatically expand the sections of Agencies’ websites that recite enforcement actions.
- Simplify and re-write in plain language the Internal Revenue Code, or at least those portions relating to simple wage-earner income taxation.
- Restrict the marketing and sale of tax products by non-tax professionals.

SUMMARY

The promotion of fraudulent schemes has grown into a cognizable service industry, with sophisticated support and distribution networks. No longer are schemes created by the lone con artist and perpetrated on a purely local level. Now, fraudulent schemes are born with the idea that they will be marketed to the masses via the Internet and multi-level marketing networks, with the criminal proceeds hidden in some distant offshore tax haven. In combating these schemes, law enforcement authorities are hampered by questions of jurisdiction, lack of resources, and criminal laws that have not kept pace with the new schemes perpetrated by scam artists.

Some steps policymakers should consider taking to slow and reverse the fraudulent scheme industry include granting federal agencies more authority and resources to restrict the marketing of these schemes, and punishing not only the perpetrators but also those who aid and abet these schemes by providing the technological resources to disseminate fraudulent schemes to the public.³

¹. <http://www.ifccfbi.gov/>

². <http://www.consumer.gov/sentinel/index.html>

³. The author wishes to thank Chris Riser, Esq., of Highlands, North Carolina, for his assistance in drafting this statement.